In the

United States Circuit Court of Appeals

For the Ninth Circuit

No. 3993

FREDERICK L. DENMAN,
Plaintiff in Error

vs.

CHARLES RICHARDSON,
Defendant in Error

UPON WRIT OF ERROR TO THE UNITED STATES DISTRICT COURT OF THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

HONORABLE JEREMIAH NETERER, JUDGE

ANSWER TO REPLY BRIEF OF PLAINTIFF IN ERROR

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We do not consider it necessary to review more than a few of the decisions referred to in the reply brief of plaintiff in error. On pages 19 and 20 of the reply brief, extracts from two opinions of Judge Neterer are set forth. In the one the action

is treated as a tort on the part of Richardson against the corporation. In the other, the action is regarded as one for money had and received. This merely indicates the changing position of counsel for the plaintiff.

But the seventh amended complaint alleges that the money of the corporation was wrongfully and unlawfully appropriated by Richardson and that, I think, is the position that counsel contends for in this court.

On page 21 of the reply brief, counsel refers to the case of *Dill v. Johnson*, 179 Pac. 608. That was an action in equity and the corporation was made a party to the proceeding.

On page 23, counsel cites the case of *Commonwealth Title Insurance & Trust Co. v. Seltzer*, 76 Atl. 77. This, also, was a case in equity and the corporation was a party to the suit and in both the Dill case and the last named case, it appeared that it was useless to ask the trustees of the corporation to bring the suit for the reason that they were dominated and controlled by the defendant, who had appropriated the money of the corporations. There is no case, so far as we have been able to find, where an action at law such as in the present case, has been sustained by any court for wrongs

done to the corporation or for money wrongfully received by an officer or trustee of the corporation involved.

On page 24, counsel cites, in support of his contention, the case of *Southern Pacific Co. v. Bogert*, 250 U. S. 482.

It is urged by the plaintiff that the reasoning of this case is controlling in the present action. As we read the case and analyze it, we reach the conclusion that it is conclusive authority in support of the contention of the defendant in this action and we ask the court to carefully read that decision. Mr. Justice Brandeis wrote the opinion in the Bogert case. In the statement of facts he says:

"In 1888 and for some years prior thereto, the Southern Pacific Company dominated the Houston & Texas Central *Railway* Company, electing directors and officers through one of its subsidiaries, which owned a majority of the Houston Company stock. In 1888, pursuant to a reorganization agreement, mortgages upon the Houston Company property were foreclosed, and these were acquired by the Houston & Texas Central *Railroad* Company; the old company's outstanding bonds were exchanged for bonds of the new; all the new company's stock was delivered to the Southern Pacific; its lines of railroad were incorporated in the trans-

continental system of that corporation; and the minority stockholders of the old Houston Company received nothing. In 1913 the appellees, suing on behalf of themselves and other minority stockholders, brought this suit in the Supreme Court of New York to have the Southern Pacific declared trustee for them of stock in the new Houston Company and for an accounting. * * *

"There had been issued by the old Houston Company 77,269 shares of stock, and by the new 100,000 shares. The decree declared that the Southern Pacific held for plaintiffs and other stockholders who intervened, 24,347.9 shares in the Houston Company, directed that it should deliver to them these shares and also in cash the sum of $702,336.61 (being the aggregate of all dividends paid thereon) and interest thereon from the times the several dividends were received, upon receiving from them 18,816 shares in the old Houston Company and also with each share of old stock delivered, $26.00 in cash and interest thereon from February 10,1891."

In its opinion the court further says:

"In considering the many objections urged against the decree, it is important to bear constantly in mind the exact nature of the equity invoked by the bill and recognized by the lower courts. The minority stockholders do not complain of a wrong done the corporation or of any wrong done by it to them. They complain of the wrong done directly by the Southern Pacific and by it alone. The wrong consists in its failure to share with them, the mi-

nority, the proceeds of the common property of which it, through majority stockholdings, had rightfully taken control. In other words, the minority assert the right to a pro rata share of the common property; and equity enforces the right by declaring the trust on which the Southern Pacific holds it and ordering distribution or compensation. The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors. If through that control a sale of the corporate property is made and the property acquired by the majority, the minority may not be excluded from a fair participation in the fruits of the sale."

The court will observe that in the Bogert case; "The wrong consists in its failure to share with them, the minority, the proceeds of the common property, of which it, through majority stockholdings, *had rightfully taken control.*"

The sale of the property by the Houston Company was rightfully accomplished by the requisite votes of the stockholders and directors. The title passed completely. An attempt was made in a former litigation involving the same subject to have the sale declared fraudulent and void, but this was rejected. The court finds specifically that the

corporation rightfully sold the property to the Southern Pacific. If the corporation sold the property rightfully, the corporation itself could not maintain an action for its recovery. The corporation under the reorganization scheme parted with all interest in the property of the Houston Company purchased by the Southern Pacific. The corporation was in no position to maintain an action to recover assets it had rightfully parted with. No cause of action existed in favor of the corporation. The corporation never had the right to maintain an action to recover the assets of the Houston Company. The action brought by the minority stockholders was therefore not a derivative action. The right to recover the property of the Houston Company never belonged to the Houston Company and the court held in the Bogert case that the minority stockholders in that case could not be construed as suing in a representative capacity for the corporation because the corporation had no cause of action itself and therefore that the action could not be derivative or representative for the reason that the corporation never had the right to maintain such action to recover the assets.

But in the present case, it is alleged that Richardson, as president and a trustee of the Pacific

Cold Storage Company, misappropriated large sums of money to his own use. It is not alleged that the money that he appropriated was voted by the corporate officers and trustees to him. The assertion is that he took the money from the treasury of the company. The Pacific Cold Storage Company was a corporation organized under the laws of the State of Washington. It was not dissolved until long after all of the alleged misappropriation of funds had occurred. If Richardson did misappropriate the funds of the corporation while it was yet in existence, it is manifest that the corporation had a right of action against him for the recovery of these assets so misappropriated. The cause of action, if any, in the first instance was vested necessarily in the corporation. If the corporation failed to sue for the recovery of this money appropriated by the defendant, then the plaintiff, before bringing a suit in his own name must have requested the trustees of the Pacific Cold Storage Company to bring the action. If the officials of the corporation refused to bring the action, then the plaintiff, of course, could maintain the action, but for the benefit only of the corporation. If the corporation were dominated by Richardson to such an extent that the corporation could not act,

the suit might be brought by the plaintiff in his representative capacity, but a complaint that fails to allege that the officers of the corporation were requested to bring a suit and refused, or that the control of the corporation was under the domination of the defendant to such an extent that the request would be useless does not state a cause of action.

If the assets of the corporation had been rightfully sold by the corporation to Richardson pursuant to requisite action on the part of the stockholders and trustees for less than their value, the corporation, being under the control of Richardson, then under the authority of the Bogert case, an action to have a trust declared might possibly be an appropriate remedy. But in a case where a wrong was inflicted upon a corporation by a president and trustee by the misappropriation of funds, the right of action rested in the corporation and in the corporation alone. No stockholder could maintain such action without making the necessary allegations contained in Equity Rule 94, as cited in our former brief. In the Bogert case the cause of action never rested in the Houston Company. In this case the cause of action to recover the funds misappropriated without the authority of the board of trustees and stockholders rested in

the corporation alone. In the Bogert case, the cause of action was a direct one and in this case the action is derivative. Again in the Bogert case, 9th subdivision, the court says:

"Equally unfounded is the contention that the Southern Pacifis cannot be held liable because it was not guilty of fraud or mismanagement. The essential of the liability to account sought to be enforced in this suit lies, not in fraud or mismanagement, but in the fact that, having become a fiduciary through taking control of the old Houston Company, the Southern Pacific has secured fruits which it has not shared with the minority. *The wrong lay, not in acquiring the stock, but in refusing to make a pro rata distribution on equal terms among the old Houston Company shareholders.*"

In the present case the wrong lay in Richardson's misappropriating the funds of the company without any action, so far as the complaint shows on the part of the governing officers or trustees of the Pacific Cold Storage Company. The distinction between the Bogert case and the present case seems too clear for doubt or discussion.

If the defendant misappropriated any of the assets of the Pacific Cold Storage Company without the rightful authority of the governing body of the corporate authorities, then he became indebted to the corporation for the amount of his misappropria-

tion. If he received money belonging to the corporation be became indebted to the company for the amount that he had taken. If he was paid money by way of compensation for services by the proper action of the board of trustees, no cause of action would rest in any one. If he did not appropriate the money under proper corporate authority, then he became simply a debtor of the corporation and subject to suit by the corporation. In other words, the corporation would have, under these circumstances, a legitimate claim against Richardson for the amount of money that he owed the corporation. He is simply a debtor of the corporation.

The effect of plaintiff's contention is that by reason of the misappropriation by the defendant, his shares of stock have been depreciated in the proportion that his number of shares bear to the total number of shares of the corporation. In other words, he is attempting to sue a debtor of the corporation for his *pro rata* or *aliquot* part as shown by the number of shares owned by him in the corporation. If plaintiff is permitted to do this in this action, it is hard to conceive of a case where a stockholder would not be permitted to sue the debtor of the corporation for funds owing to the corporation. The long and unbroken line of au-

thorities holding that a stockholder cannot sue directly a debtor of a corporation for moneys owing by him to the corporation, would be swept aside. Had it been the intention of the supreme court in the Bogert case to overrule and set aside all of the former decisions of the supreme court and other courts holding that a stockholder cannot sue directly to recover money from a debtor of the corporation without first requesting the corporation to institute the action, it certainly would have so stated in unmistakable terms. On the contrary, the court does not overrule such authorities but makes the distinction and holds that the facts in the Bogert case did not bring that case within the general rule as set forth in the authorities in our former brief. If this action can be maintained by the plaintiff directly against Richardson, who is alleged to have received money from the corporation and to be a debtor of the corporation, it is difficult to conceive of any case where a stockholder would be denied the right to sue a debtor of the corporation directly, measuring his injury and damages by the proportionate amount of the capital stock of the company that he owned.

The complaint does not state that the money was paid over to Richardson by the corporation, acting

under any resolutions of its governing bodies. The allegation is that he took the money wrongfully and without authority. He owed the duty, if he did, to restore it to the company. There can be no question that the corporation could recover this money if it were taken wrongfully. Therefore it necessarily follows that in effect plaintiff is bringing an action in his represenative capacity for the reason that the corporation or trustees appointed by statute have failed to do so. He has failed to make allegations conformable to equity rule 94. He has failed to make the corporation a party and to show that he has requested the corporation to institute the suit or that it would be useless to do so by reason of the control being vested in Mr. Richardson.

Counsel, on page 23 of the reply brief, cites the case of *Erwin v. Ore. Ry. & Nav. Co.*, 20 Fed. 577.

The same distinction was made by the court in that case, as in the Bogert case. There the O. R. & N. Co., an Oregon corporation, dissolved itself and sold its assets to another company, under the compelling influence of a majority of the stockholders, who went in control of the company. A trust was declared in that case and it was held that the O. R. & N. Co. was not a necessary party. In

that case, too, the court expressly holds that the property was rightfully transferred and conveyed by the old corporation to the new but for an inadequate consideration. A trust was declared. The court held that the action was not derivative or representative, but that inasmuch as the property was rightfully sold by the corporation, the corporation, had no longer any interest in it but that a trust was created which could be enforced without joining the old corporation. It did not hold or intimate that the old corporation had any right of action to recover the property, but on the contrary held that it did not have such right because the corporation was dissolved and the property sold in accordance with the corporation laws of Oregon and with the by-laws of the corporation. It did not hold that an officer or trustee who had misappropriated any of the property without right during the existence of the corporation would be liable to an action on the part of a minority stockholder. In other words, the action is in no sense derivative or representative as in the case at bar.

Counsel also cite the case of *Barker v. Edwards*, 259 Fed. 484, in support of their contention that neither the corporation nor the statutory trustees upon its dissolution, are necessarily parties in an

action to recover the property of the corporation by a stockholder acting independently and not in his representative capacity. An examination of the case, however, wholly fails to bear out plaintiff's contention. Counsel seem to rely very strongly upon this case but it has not the remotest application. This was an action in which certain shares of stock in the Big Seven Mining Company were claimed by two parties. The action was brought to try the title to the shares of stock after the dissolution of the corporation by the expiration of its charter. The real estate of the corporation merely took the place of and became substituted in law for the shares of stock. Had the corporation not been dissolved, under no conditions would it have been necessary to make the corporation a party to the litigation. The court held that upon the dissolution of the corporation the title to the property became vested in the stockholders and that under section 4545 of the revised codes of Montana the grantee or devisee of real property subject to a trust acquires a legal estate in the property as against all persons except the trustees and those lawfully claiming under them. The court says further in the opinion:

"It is said that this is an action to determine title to stock and to have title to stock decreed in trust

for the estate of Jane Barker, deceased, and that, therefore, all the heirs and legatees of the estate are necessarily interested parties, and in no way antagonistic to the claim of plaintiff, except David L. S. Barker, and that all the heirs and the executor and executrix are indispensable parties."

It was not contended that the corporation in this case should be made a party to the suit, or that the statutory trustees were necessary parties. The real objection to the jurisdiction was that the executor and heirs of the estate of Jane Barker were not made parties to the suit.

The court in the Barker case undertook to construe the powers of trustees of a dissolved corporation under the Montana statute, but this was not necessary to the decision but was merely dictum. Furthermore, we do not see how it could have been possible for the trustees of the dissolved corporation to have ever had the right or power to bring an action to determine the ownership of the 427,000 shares of stock in the mining company. The cause of action never rested in the mining company, hence the plaintiff could not be held to have brought a derivative or representative suit. Neither the trustees nor the corporation had the right or power to determine in the first instance the ownership either of the stock or the land which represented the stock

after the dissolution. In fact none of the cases cited by counsel have any application to facts such as the facts in the case at bar.

The fundamental distinction is that the corporation is an indispensable party if the cause of action originally rested in the corporation. For the foregoing reasons, and upon the authorities cited in our former brief, we earnestly contend that the corporation is an indispensable party and that the complaint does not state a cause of action in that it fails to allege that neither the corporation nor the statutory trustees were ever requested to institute suit prior to the commencement of this action. The complaint must fail for want of equity for the reason that it does not comply with equity rule 94.

We desire to call the court's attention to the fact that there is no proof in the record that Charles Richardson dominated or controlled the board of trustees of the corporation or controlled the liquidating trustees fixed by the statute.

All requirements of equity rule 94 apply to all equity actions of this character commenced in the federal courts. They likewise are applicable to an action commenced in a state court and afterwards

removed to the federal court. The same requirements of the equity rule control cases removed from the state court, even though the laws regulating the state courts do not compel the plaintiff to allege the requirements of equity rule 94.

Venner v. G. N. Ry. Co., 209 U. S. 24, 153 Fed. 408.

At the conclusion of the oral argument, counsel asked leave to file a brief in support of his contention that the defendant could not raise in the appellate court for the first time the contention that the complaint failed to state a cause of action. No authorities are cited by counsel in his reply brief upon this point and it is plain that no such authorities exist. If the action be regarded as a suit in equity, it fails to state a cause of action in that it fails to show any compliance, or attempted compliance or excuse for the requirements prescribed by equity rule 94. If it be regarded as an action at law, it likewise fails to state a cause of action for the reason, among others, that there was no privity of contract existing between the plaintiff and the defendant. The cause of action was vested in the corporation or in the liquidating trustees. None of the authorities cited by counsel disclose any facts at all similar to those involved in this action. The

only reason that a stockholder was permitted to commence an action in equity was due to the fact that he had no remedy at law, so that plaintiff may take either horn of the dilemma that he chooses. He must fail, whether the action be regarded as one in equity or one at law.

Respectfully submitted,

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